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Testimony of
Richard C. Breeden
Before the
Subcommittee on Finance and Hazardous Materials
Committee on Commerce
U.S. House of Representatives

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Mr. Chairman and Members of the Subcommittee:

It is an honor and a distinct pleasure to appear before you today. I am President of Richard C. Breeden & Co., which provides turnaround management and advisory services to companies in distress situations, including bankruptcy or financial crisis, whether as a result of fraud, severe underperformance or mismanagement. Breeden & Co. also provides strategic consulting services on global capital markets, major international financings, independent reviews of ethical or regulatory problems, and other consulting services.[1]

Since my last appearance before the Subcommittee, you have had a few changes. I hope that the change of the name of the Subcommittee from "Telecommunications and Finance" to "Finance and Hazardous Materials" was not intended to be prophetic. After incurring the wrath of the plaintiff's bar and state securities regulators in calling for litigation reform and partial preemption of state blue sky laws, I was delighted to see passage of legislation in these areas, as the many other simplifications contained in the National Securities Market Improvements Act. With these pieces of legislation, the Committee has made very important improvements that will have a positive impact on our securities markets for many, many years. Of course this follows in the traditions of this Committee, which has shaped America's securities markets for generations, along the way helping to create a system for allocation of capital to promote entrepreneurship and growth that is simply unequalled in human history.

You have asked me to address (I) how securities firms owned by banks should be regulated; (ii) whether the Federal Reserve should create a new regulatory program of "consolidated supervision" for such organizations; and (iii) how to protect the entrepreneurial aspects of securities markets so that they do not become a bureaucratized clone of banking regulation. At the outset, let me emphasize that I have the highest possible regard for the Federal Reserve, and the professionalism and skill of the men and women who work there. It is among the finest agencies in the world of any type, and certainly it is one of the leaders of the world's central banks. This does not mean that "consolidated supervision" of securities firms would be good for the Fed, or good for the market. Sometimes, as Adam Smith described, sticking to what you do best and letting others do what they do best works out the best for everyone. Cf A.Smith, <u>The Wealth of Nations</u>.

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[1] As required by the rules of the Committee, I have attached a copy of my biography and a statement attesting to the lack of any federal contracts.

To save most people the trouble of reading any further, I will provide my answers before my reasoning. The answers are clear and they are simple. First, securities firms acquired by banks should be regulated exactly the same as securities firms not owned by banks. Second, the SEC and only the SEC should perform the oversight function as it has proven it knows how to do, and the Federal Reserve Board should not have any role in "consolidated supervision" over the securities industry or bank securities affiliates. Third, entrepreneurialism comes from the interplay of free market forces. If government subsidies (such as deposit insurance and sovereign credit) and the oversight that absolutely must attend the use of such subsidies are introduced into the securities markets, then the dulling, narcotic effect of those subsidies and the related bureaucratic nannyism will work a prompt and significant alteration on the culture of Wall Street. The current system has actually done a fairly good job of balancing opportunities for banks to compete in the market, but doing so without making changes to the basic legislative framework for issues such as capital requirements, sales practices, antifraud standards, registration and disclosure requirements and other vital areas where the SEC remains the final arbiter. My recommendation concerning proposals to defang the SEC and turn many of these issues over to committees of bank regulators was best expressed by Nancy Reagan: "Just say No."

A. FUNCTIONAL REGULATION

During my tenure as Chairman of the Securities and Exchange Commission, I testified on behalf of the Commission in support of legislation to broaden opportunities for banks to compete in a wider range of securities activities, *if and only if* any such change was coupled with a system of “functional regulation”. Functional regulation is an extremely simple principle of applying all the normal rules governing the securities business to all firms engaged in the business, without exceptions, carveouts, or special privileges. Under our approach, every batter at the plate would get four balls and three strikes called by the same umpire, irrespective of whether the firm was a traditional independent broker dealer, or whether it had corporate affiliates that were banks, insurance companies, manufacturing firms or held equity ownership interests in any other line of business[2].

Functional regulation is designed to protect the investing public by eliminating unwarranted gaps in investor protections. By requiring broker-dealers owned by banks to be subject to all the same rules as other securities firms, enforced by the same expert regulatory personnel, functional regulation is also the best protection against tampering with the chemistry of entrepreneurial culture, risk-taking and absolute market discipline that are among the hallmarks of the U.S. securities market. At that time the Commission believed that if the price of allowing banks to own securities firms was to pollute the securities market with bank regulatory concepts and practices, then that price would simply be too high to pay. The vast liturgy of bank safety and soundness regulation, including the exalted “umbrella supervision” of holding company regulation, might be suitable to the world of banking, but the application of these rules to securities markets

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[2] Even at that time, the SEC had the greatest level of experience with financial diversity in the types of firms subject to its regulatory oversight. Firms such as General Electric, Prudential Insurance, American Express

would dramatically weaken the level of investor protection and seriously undercut the financial stability that have been required in the U.S. capital markets for more than 60 years.

Since leaving the SEC, my perspectives have been broadened by consulting with major U.S. and foreign financial firms, as well as with several governments considering modernization of their financial systems. I have worked with major foreign issuers of equity securities in the U.S. market, and I have worked with several banking institutions seeking to integrate compliance, risk management and other vital systems across banking and securities affiliates around the world. This is an immensely complex task for firms, given the differences in local requirements across national and product lines. These experiences have reinforced my views about the wisdom of functional regulation. It is simply the right answer as to how best to protect investors, and also how best to reduce regulatory costs by knowing whose rules govern.

My perspective has also been affected by my experiences over the past year, when I have served as the bankruptcy trustee of The Bennett Funding Group, Inc. ("BFG") and eight of its affiliated companies that are now in bankruptcy. BFG was the scene of what we believe is the largest pyramid fraud (Ponzi scheme) in U.S. history. More than 12,000 individual investors were sold more than $2.1 **billion** in unregistered and fraudulent securities as part of this scheme involving an equipment leasing concern in Syracuse, New York. Investors were sold interests in equipment leases to state and

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and J.P.Morgan had all competed against independent securities firms and each other, all using the SEC' as federal agencies (including the Library of Congress, Department of the Navy, Federal Reserve, New York City Transit Authority, State of Florida, etc.), as well as leases to businesses that were said to be fully insured by two major foreign insurance companies. These investments were sold largely to elderly investors looking for safe investments with an attractive yield. Unfortunately, more than $100 million of the "ultra-safe" leases never really existed, and leases that were real were first pledged to banks and then sold as many as 7 times to different investors. Money investors thought was going to purchase leases was actually being used to pay off other investors who purchased phony leases, and to fund a series of highly speculative and ultimately disastrous investments in gambling and real estate ventures.

When BFG collapsed, it left liabilities of more than $1 billion owed to creditors in 46 states. We are now fighting hard to recover as much as possible to repay the creditors, who also include 245 banks and one major insurance company. During my time at the SEC I brought enforcement actions in more than 1,200 cases, many of which involved violations of the antifraud provisions of the federal securities laws. Though I understood the importance of those laws as a lawyer and a government official, there is nothing that equals the impact of listening to hundreds and hundreds of 70 and 80 year old investors tell you about losing their houses, their life savings, their children's or grandchildren's inheritances, or simply the means to enjoy the remaining years of their life because of purchasing phony securities.

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the regulator of their securities activities.

The magnitude of a tragedy of this kind is very hard to comprehend, with a devastating impact on thousands of innocent people. Such circumstances create an understandable loss of faith in the legal protections and institutions of justice that are intended to prevent such occurrences. Repeated on a broader or more frequent scale, as has happened in Russia, Albania and other emerging markets, it is easy to see that the willingness to participate in capital markets would be severely damaged, potentially for decades, and trust in government shattered. Detecting and shutting down such schemes is a full-time job, and it is a rather far cry from formulating monetary policy.

I set forth these experiences simply to provide a backdrop for my views on the issues that the Committee asked me to address of how securities firms acquired by banks should be regulated, and whether the Federal Reserve should be given authority to exercise "consolidated supervision" over organizations that include both bank holding companies and securities affiliates. There is in my view quite a bit at stake for our economy and tens of millions of investors in how Congress answers these questions in the future.

In addition to the philosophy for adopting functional regulation that I describe above, I believe there are several other reasons why functional regulation is an absolutely critical element in our future regulatory system.

1.1. More Americans than ever before in our history are investing in our securities markets, and especially in equities. Both directly and through mutual funds, the number of investors and the amount of aggregate investment have risen to unprecedented levels. The number of families relying on securities investments to provide for their children's college education, their own medical and retirement needs and for reposing a significant share of the family's accumulated wealth has risen noticeably over the past few years.

1.2. This growth in investing has provided significant strength to the economy, and it has provided the capital that has allowed U.S. firms to become among the most productive in the world. The U.S. securities market provides our economy with vast liquidity at the most competitive prices, and in a far more innovative variety of forms as to structure, term, and risk characteristics. This has also brought foreign firms flocking to issue securities in this innovative and efficient market.

1.3. The wide open U.S. capital market provides more capital to venture stage and startup businesses than most of the rest of the world's capital markets put together. So many of the basic technologies that have driven the growth of the information age have been developed in the United States largely because of the fact that in the U.S. smart nerds can raise a lot of money through IPOs. This has required a risk-taking approach both among underwriters and investors, but it has paid enormous dividends to our economy and in improving the quality of our everyday life.

1.4. We have the world's largest securities market in large part because we have long provided by far the world's best protection for investors. For decades we have required broad disclosure of information, prohibited manipulation, applied stringent accounting and transparency standards and prosecuted violators effectively. By doing so, and by avoiding the temptation to weaken the protections for the buy side of the market in response to pressure from various quarters, we have steadily built confidence in the quality of our product: the integrity of the market. Because we built a market with genuine integrity, and the transparency and fairness of the market have not been compromised for any other bureaucratic or business goal, tens of millions of investors have chosen to participate with trillions of dollars.

1.5. We should never take the level of participation and liquidity in our markets for granted. While aggregate investment is higher than ever, so too is market volatility. Confidence is a fragile element that takes years to develop and can be shattered quickly. My experience at BFG, as well as in markets around the world, is that people consistently underestimate the psychological impact of a massive fraud. Few things are as corrosive and deadly for the health of the market, or morally worse, than cases of major fraud. Detecting and combatting fraud effectively are not easy, and no other country has been nearly as successful as the U.S. in ***enforcing*** laws against fraud on investors.

1.6. Bank regulatory agencies have the job of overseeing securities activities of banks in many other countries. Not one of those countries has developed a securities market with the innovation and growth of the U.S. market, and not one of them has a truly effective enforcement program. The global trend is definitely to transfer authority away from central banks and to create specialized regulators on the model of the U.S. Securities and Exchange Commission. In addition, few countries with bank regulators in charge have developed a successful securities market, suggesting that notwithstanding their skill and professionalism, the goals and priorities of bank regulation (e.g. safety and soundness) may not engender the necessary widespread investor confidence in the domestic market.

1.7. In most countries, there has not been any Glass-Steagall barrier to banks engaging in the securities business. In countries as diverse as Germany and the United Kingdom, banks have not generally built successful securities firms through internal growth[3], though they were not restricted from doing so. Rather, when they decided to enter the securities and investment banking worlds in a major way they have typically turned to acquisition of existing U.S. or U.K. independent securities firms. Since these banks had both the intellectual and financial capital to develop an investment banking business but were unable to do so internally, the style and culture of globalized bank regulation may simply be incompatible with the free-wheeling, deal-oriented mentality that makes for the development of a successful securities firm.

1.8. The U.S. capital market structure is anything but broken. In global terms we have the most liquid, efficient and innovative market. We develop new instruments to enable the most efficient capital structure for businesses, and we have been the leader in applying technology to both trading activities and risk management systems. Our market is far from perfect, but both U.S. banks and U.S. securities firms are very successful both domestically and globally.

1.9. For nearly 20 years in my memory, and I am sure for much longer, Congress has been discussing the need to "modernize" the U.S. financial system. Since in most respects the U.S. financial system is by far the most modern in the world, there is a certain air of artificiality about these discussions. It has been *de rigeur* to pronounce that a profound or "comprehensive" set of reforms was needed. This has not proved necessary in the real world as demonstrated by the fact that banks are today widespread participants in almost every facet of the securities markets.

1.10. Fortunately, rather than being led by Congress, market reform has been largely the product of market forces and technology. Products with revolutionary impact such as asset backed securities of all types and mutual funds have come from market innovation, with government's role being to look out for protection for the investing public, not trying to engineer systemic reforms.

1.11. Banks have too long been hampered from participating in the securities and broader capital markets by overly broad legislation. However, while banks should be "liberated" from many unnecessary restrictions emanating from their traditional

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[3] There are, of course, a few exceptions to any generalization, including this one.

regulation, bank regulatory agencies have typically demanded that banking law should continue to retain outdated special preferences and exemptions from securities laws. This is not a desirable formula. Simple functional regulation would allow greater bank competitive roles while avoiding any damage to the market itself.

B. CONSOLIDATED SUPERVISION BY THE FEDERAL RESERVE

"Consolidated Supervision" of the securities and insurance affiliates of companies that also own banks doesn't sound, on its face, like a terrible thing. "Monopolized supervision" might not sound quite so appealing. The reality is that this issue is about bureaucratic turf, and really nothing more.

Under "functional regulation", the regulator of a bank, a securities firm and an insurance company that are all owned by the same company each regulates their respective type of regulated entity. If the securities or insurance regulator wants to take regulatory or enforcement action against the firm it regulates, it doesn't need the permission of the bank regulator. Consolidated supervision is a polite term for saying that in any such situation the bank regulator is the boss, and in case of a difference of approach the securities or insurance regulators are neutered.

Since at least my time at the SEC, "consolidated supervision" has been a major objective of the Basle Committee on Banking Supervision, the global committee coordinating the supervisory efforts of bank regulators.[4] During part of this time I served as President of the comparable committee for the International Association of Securities Commissions, the counterpart body for securities market regulators. We sought without luck to identify situations where "consolidated supervision" had actually worked in practice in markets with highly developed securities markets, except in a system of universal banking where it is unnecessary. At IOSCO we preferred a system of "coordinated supervision", in which expert regulators worked actively together without a master-servant relationship.

One argument for hegemonic bank regulation on a consolidated basis is that financial "contagion" will necessarily spread from one unit to the rest of a holding company. This is true if the problem in a unit is big enough, though it doesn't really prove what should be done about it. The hole sinking the Titanic is just as likely to be in the bank affiliate as it is to be in the securities or insurance affiliate, and there is no guarantee of which type of agency is automatically going to spot the iceberg before it is too late. In such a situation it has always seemed to me that three lookouts were better than one, with the banking, securities and insurance regulators each looking out for (and being strictly accountable for) their own regulated entity, and each having the power to obtain critical information concerning the parent or other affiliates on an ongoing or

[4] The Basle Committee is a highly respected group that brings together many of the most thoughtful people in the world concerning bank regulatory issues. However, the issue of consolidated supervision, like other issues, may have an impact in the United States that would be different than most of the rest of the world, due to the unique role of securities markets and firms in the U.S. and the presence of the comprehensive regulations of the SEC that are generally not replicated in most other markets the Basle group is concerned with.

special need basis. Monopolizing anything, whether in government or business, does not typically improve its performance. Supervision is no exception.

The failures of Drexel Burnham and Barings are both interesting examples of this issue. In both cases the problems within one unit of a firm were big enough to cause the failure of the entire firm unless the government was willing to step in and guarantee the firm's liabilities, which both the U.S. and U.K. governments refused to do. In the home markets, there was not consolidated supervision of the holding company in one case, and there was in the other. Both disasters occurred, and neither system of regulation prevented them. In both cases, the public and the markets were protected, and taxpayers didn't have to foot the bill. It is difficult to see a case for change in the U.S. system given the successful experience with Drexel, which proved that market disciplines work and that the regulated entity and its customers can be separated while the parent is allowed to go into bankruptcy. As long as each car of the train can be uncoupled and left on a siding if it gets in trouble, the system will work just fine without extra regulation.

In this area, there is simply no evidence that going from a system of co-equal regulators to a master-servant system will accomplish anything except to add a new layer of bureaucracy that we don't have now. If Alex Brown & Sons has operated successfully for more than 150 years without supervision by the Federal Reserve, why should it need it now just because Bankers Trust owns its stock[5]? As long as BT isn't allow to make uncollateralized loans to Alex Brown on a non-arms length basis, or otherwise to put

BT's capital at risk in Alex Brown, Alex Brown could be separated from the BT holding company either if Alex Brown was failing, or if BT was failing. Here again, keeping the experts in charge in their respective areas seems the safest course -- two lookouts rather than one.

2.1. "Consolidated", "umbrella", "holding company" and similar overarching prudential regulatory regimes have not proven successful at preventing either financial or ethical debacles. Notwithstanding consolidated oversight by the Bank of England, both the Barings and BCCI disasters occurred in the U.K. Consolidated oversight by the Bank of Japan and, in the U.S., by the Federal Reserve, did not prevent the Daiwa and Sumitomo situations. Holding company regulation did not prevent more than 2,000 banks and thrifts to fail in the United States during the late 1980s, or the trading scandals at Bankers Trust in more recent years. The SEC too has had scandals and financial debacles on its watch. No agency is perfect, and nobody is going to spot every problem situation.

2.2. Aside from the fact that consolidated supervision would be very costly, and there is no evidence that it would add anything in real terms to market stability, it is possible that the effect of any such policy would be to **weaken** both safety and soundness and investor protection. The broader an agency's mandate, the more difficult it is for the agency to be able to have adequate specialized knowledge of very narrow areas within a single market. In recent years the major scandals and financial collapses have generally

[5] Assuming the proposed transaction is completed.

not occurred because of “cross industry” problems within a group of affiliates, but rather within a single area or business, such as fixed income, derivatives, investment advisory services, trading standards, sales practice abuses, accounting failures or poor risk underwriting . Stopping such problems at the earliest time requires specialists who know their particular field well enough to spot even carefully hidden problems, not broad generalists who are trying to coordinate supervision of the planet.

2.3. Consolidated supervision is predicated on the express or implicit assumption that some types of regulation, e.g. safety and soundness of banks, are more important than others, e.g. antifraud protection of retired schoolteachers. If nothing else, this assumption of the primacy of safety and soundness creates an irresolvable regulatory conflict of interest for a “consolidated” regulator. Certainly the enforcement sanctions against Prudential Securities weakened, at least in the short term, the “safety and soundness” of Prudential Insurance. However, companies that have engaged in fraud on investors in a serious and knowing manner should have to disgorge their profits and pay substantial civil penalties, even if their bond rating goes down or , in an extreme case, they fail. That should be a concern, but not the overriding concern, for the person with the job of restoring funds to someone who has been defrauded. Large and painful enforcement actions that may damage one firm’s P&L or balance sheet, at least temporarily, also produce a deterrent effect to others far more powerful than millions of dollars in regulatory expense.

2.4. Rather than smothering those whose job it is to crack the kneecaps of fraud artists and con men under warm and fuzzy layers of consolidated preemption by bank regulators, Congress should allow the healthy tension that has served the country enormously well to continue. If Congress hears both points of view, rather than subsuming one under the other, you will have a better overall picture. Making the head of the SEC a second-lieutenant of the Federal Reserve, the Treasury or , worst of all, a faceless "Interagency Committee" , will most likely make the job less appealing to the people of stature you should want to be attracted to it. Worse, making the SEC's ability to pull the trigger on wrongdoing subject to Washington inter-agency politics would make it a less attractive place for bright and talented young securities lawyers to work. The world is full of countries with securities regulatory rulebooks, but with only sporadic or ineffectual enforcement. This would be an enormously costly step for our country.

2.5. If you really want successful consolidated regulation, let the market do it. Market disciplines are far tougher than regulatory requirements most of the time, as long as the accounting and disclosure requirements embody a level of timeliness and transparency sufficient to allow the market to identify risk profiles, and as long as government subsidies do not preclude market forces from working. [6]

2.6. It is worth remembering that the American economy is full of thousands of holding companies, large and small. G.E., G.M., Microsoft, Mobil, IBM, and probably

[6] Both the Fed and the entire banking industry regard mark to market accounting for securities as anathama, yet this is a critical daily market discipline for securities firms that has been instrumental in keeping securities firms solvent in the worst market downturns.

499 of the Fortune 500 are holding companies. No agency of the United States government has to regulate them to provide “consolidated supervision” or “prudential oversight” just because they are a holding company. That is why they have boards of directors and senior management, backed up by the requirement to disclose material information to the market as a whole. If one of their subsidiaries is in a regulated business, the regulator of the regulated business oversees that subsidiary. However, it is the market, not a bureaucracy, that provides the overall discipline. Strong companies pay less for capital than weak ones, as well as typically having stronger stock prices and therefore more remunerative executive stock option plans, which provides ample incentives to achieve the greatest possible overall shareholder value. The market’s discipline, coupled with high quality boards of directors, is the traditional system for regulating holding companies, and it is still the best such system.

C. ENTREPRENEURSHIP

The best analogy I can think of to the challenge of preserving an entrepreneurial culture on Wall Street if banking regulation is imposed on the industry is like trying to insure that China will not change Hong Kong after it takes over. You can write a treaty and hope for the best, and time will tell. Perhaps nothing will change, and the Chinese have strong incentives to keep Hong Kong as strong and vital as it is today. Nonetheless, it is impossible to predict how the change in control will affect the market in subtle but real ways.

The level of entrepreneurship, innovation, competition and efficiency of the U.S. securities market is the highest in the world, and a major economic asset of the United States. Tampering with a system that works to prevent failures of securities firms without government rescues and that generates confidence among investors would be warranted if the system wasn't working, but it is hard to fathom given the success we have enjoyed. Our system of "competition" among regulators with admittedly different agendas serves the public well, even if it doesn't always look like a diagram in a consultant's report.

If, however, there is to be a "consolidated" oversight, it should be through the uniform enforcement of high quality public disclosure and accounting rules. This approach will allow independent directors, creditors and investors to make the most fully informed and well-protected decisions, and in so doing they will provide all the discipline ne`cessary for a strong and healthy financial system..